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In the Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-1374

GARLOCK, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (App. A-1—A-28)[1] are reported at 58 T.C. 423. The opinion of the court of appeals (App. B-1—B-12) is reported at 489 F. 2d 197.

JURISDICTION

The judgment of the court of appeals was entered on December 12, 1973. The petition for a writ of

[1] "App." references are to the separately bound appendix filed with the petition for a writ of certiorari.

certiorari was filed on March 11, 1974. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether both courts correctly held that Garlock, S.A., a Panamanian corporation, was a "controlled foreign corporation" within the meaning of Section 957(a) of the Internal Revenue Code and the Regulations thereunder, because petitioner owned "more than 50 percent of the total combined voting power of all classes of stock entitled to vote" of that corporation.

2. Whether Section 951 of the Internal Revenue Code, which requires United States shareholders to include in income their share of the earnings of their controlled foreign corporations, is constitutional.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Sections 951 and 957 of the Internal Revenue Code of 1954 and of Section 1.957–1 of the Treasury Regulations on Income Tax (1954 Code) are set forth in the Appendix, *infra*.

STATEMENT

During 1964 and 1965, the years in issue, petitioner was a publicly owned New York corporation which manufactured and sold industrial components such as gaskets, packings, and seals. In 1958, it organized a Panamanian corporation, Garlock, S.A., to market its products in Europe and Asia. Through December 1962, Garlock, S.A., had one class of common stock issued and outstanding, all of which was owned by petitioner (App. A–2—A–3, B–3).

On December 4, 1962, petitioner's president submitted a written report to its board of directors proposing a recapitalization of its Panamanian subsidiary.[2] The report noted that after January 1, 1963, newly-enacted provisions in the Revenue Act of 1962 would require that Garlock, S.A.'s earnings be included in petitioner's taxable income whether or not those earnings were repatriated as dividends (App. A–4, B–3). The report stated that "[t]o avoid this tax result it will be necessary to change the capital stock structure and voting rights in such a way that Garlock, S.A., will no longer be a 'controlled foreign corporation' as defined in the Revenue Act" (App. A–4, B–3).

The report suggested the following revisions to the capital structure of Garlock, S.A., all of which were approved by petitioner's board of directors. Pursuant to the plan, petitioner would retain a $100,000 common stock investment (1,000 shares, $100 par) and a new issue of $100,000 cumulative preferred stock (1,000 shares, $100 par) would be created—the preferred shares to be entitled to one vote along with each common share (App. A–5, B–3). The plan was "to pass 50% of the voting rights to foreigners," who would "not have any interest in exercising their vote independently" of petitioner, who understood "our motives" and who would be "willing to vote their stock

[2] At the time of this recapitalization, petitioner's original $50,000 investment in S.A. had grown to $587,413 (Ex. I).

with us in return for an ample dividend rate—probably 8%" [3] (App. A–5, B–3).

The report pointed out that petitioner would be protected from loss of actual control because Garlock, S.A., had to consent to the transfer of preferred stock. The report mentioned two foreign investors who had been approached and who had stated that they "understood the situation" (App. A–5, B–4).

On December 26, 1962, when petitioner was still the sole stockholder of Garlock, S.A., the recapitalization under Panama law was duly approved at a special stockholders' meeting. At the same meeting, the articles of incorporation were also amended to provide for the election of directors by a majority vote for terms of from one to five years, the term to depend upon the vote at the time of the election. Petitioner thereupon selected four of its officers to be directors of Garlock, S.A., for five year terms or "until their successors were elected and qualified" (App. A–6–A–8, B–4).

One of the two foreign investors mentioned in petitioner's president's report was a Bahamian corporation, Willard International Financial Co., Ltd. ("Willard"), whose counsel was the same law firm serving as petitioner's tax counsel. Willard was the parent corporation of Camdex Investments, Ltd. ("Cam-

[3] Although petitioner claims (Pet. 4–5) that a principal reason for the recapitalization was to acquire additional capital for certain foreign transactions, neither court below accepted this contention. The normal acquisition practice of Garlock, S.A., was to use its own capital or to borrow funds which petitioner would guarantee (Tr. 98–99, 136–137, 159–160, 199).

dex"), a Canadian corporation. On January 29, 1963, Camdex subscribed to the 1,000 shares of Garlock, S.A., preferred stock with money from its parent. It retained only 10 percent of the 1,000 shares and sold the balance to three foreign investment companies.[4]

The subscription agreement provided (1) that the preferred shares were transferable only with the prior written consent of the board of directors of Garlock, S.A., which was not to be "unreasonably withheld"; (2) that Garlock, S.A., was to maintain a net current asset or working capital position of at least 200 percent of the total par value of the preferred stock, failure of which would require it to redeem the preferred stock at par upon demand; and (3) that the preferred stockholders were to have their stock redeemed at par at any time after one year from date of issue upon 120 days' written notice. At the time of the issuance of the preferred stock, the 8 percent dividend rate it carried exceeded the interest rate prevailing in the foreign market (App. A–5, A–8—A–14; B–4—B–5.)

On October 1, 1963, the number of Garlock, S.A., directors was increased from four to five. At all times, petitioner maintained a majority on the board since three of its officers were directors. These directors were re-elected at both the April 1964 and April 1965 stockholders' meetings. Prior to these annual meetings, the preferred stockholders had executed proxies

[4] In a letter to Willard's president, an officer of petitioner indicated that Camdex would retain at least 10 percent of the issue (App. A–10).

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enabling petitioner's officers to vote their shares without the preferred stockholders' knowledge of what would be voted on at the meeting (App. A–15—A–17, B–5—B–6).

The Commissioner of Internal Revenue determined deficiencies against petitioner for the years 1964 and 1965 on the ground that Garlock, S.A., was a controlled foreign corporation within the meaning of Section 957(a) of the Code and the Regulations thereunder. Looking to the substance of the transactions, the Tax Court unanimously held that petitioner's transfer of voting power of Garlock, S.A., to the preferred stockholders was illusory and that the petitioner had retained stock with more than 50 percent of the voting power of Garlock, S.A. As a result, it concluded that Garlock, S.A., was a controlled foreign corporation (App. A–24). The Tax Court also held that it was constitutionally permissible to tax petitioner, under Section 951 of the Code, on its share of the income (App. A–26—A–27). The court of appeals unanimously affirmed (App. B–10—B–12).

ARGUMENT

1. As part of the Revenue Act of 1962, Congress added Subpart F (Sections 951–964)[5] to the Internal Revenue Code, in order to eliminate tax deferral privileges for United States shareholders who sold goods manufactured in the United States through controlled foreign subsidiaries organized in tax haven countries. Section 957(a), Appendix, *infra*, defines the term "controlled foreign corporation" as a foreign corpora-

[5] Section 12(a) of the Revenue Act of 1962, 76 Stat. 1006.

tion "of which more than 50 percent of the total combined voting power of all classes of stock entitled to vote is owned * * * by United States shareholders * * *." Pursuant to Section 951, Appendix, *infra*, a United States shareholder of a controlled foreign corporation must include in income his pro rata share of his controlled foreign corporation's Subpart F income, as defined in Section 952.

As the court of appeals noted (App. B–2), there is no dispute that petitioner was a "United States shareholder" within the meaning of Section 951(b) and that all of the income of Garlock, S.A., was Subpart F income. The principal question presented is whether petitioner "owned" more than 50 percent of the total combined voting power of Garlock, S.A., so as to classify it as a "controlled foreign corporation" under Section 957(a).

With respect to a determination whether a United States shareholder owns more than 50 percent of the total combined voting power of a foreign corporation, the Commissioner has provided in Treasury Regulations, Section 1.957–1(b), Appendix, *infra*, that no effect is to be given to any arrangement shifting formal voting power away from United States stockholders of a foreign corporation if the voting power is actually retained. After stating that the determination whether United States stockholders own 50 percent or more of the total combined voting power turns upon the facts of each case, the Regulation provides that even if United States shareholders have the power directly to vote only one-half or less of the total stock, they will be regarded as owning more than one-half of

the total voting power if an agreement or arrangement exists by which they control the corporate operations and policies.

This Regulation is but a restatement of the familiar principle that taxation depends on substance and not on form. See, *e.g.*, *Knetsch* v. *United States*, 364 U.S. 361, 365; *Higgins* v. *Smith*, 308 U.S. 473; and *Gregory* v. *Helvering*, 293 U.S. 465. The Regulation is valid since it is reasonable and consistent with the statute. *United States* v. *Correll*, 389 U.S. 299, 307; *Bingler* v. *Johnson*, 394 U.S. 741, 750–751.

When this case is examined in the light of the "substance over form" tax principle of the Regulation, the only permissible conclusion is that reached by the Tax Court and the court of appeals, *viz.*, that petitioner owned more than 50 percent of the total combined voting power of all classes of stock entitled to vote in Garlock, S.A. The transfer of preferred shares of Garlock, S.A. to foreign entities was nothing more than a cosmetic device which did not shift any voting power in Garlock, S.A., away from petitioner.

As the undisputed facts demonstrate, petitioner sought out foreign persons who were willing to vote their stock with petitioner. It made the stock offer sufficiently attractive to entice and keep the foreign shareholders compliant to petitioner's will through a return in excess of market rates on the stock and a promise to redeem the stock at par on demand when either the working capital or current net asset value of Garlock, S.A., fell below 200 percent of the total par value of the preferred stock or at the end of one

year, on 120 days' notice. Transferability of the preferred was by permission of Garlock, S.A.'s board of directors, which had been and were selected in such a manner as to insure petitioner's continued control over Garlock, S.A. During the years at issue, these preferred shareholders went through the form of signing proxies enabling petitioner's officers to vote their shares without having any knowledge of what would be voted on at the stockholder's meetings.

In light of this arrangement whereby the Garlock, S.A., preferred shares were voted entirely in accordance with petitioner's wishes, it is beyond question that petitioner owned more than 50 percent of the total combined voting power of that corporation within the meaning of Section 957(a) and Treasury Regulations, Section 1.957–1(b).[6] Thus, contrary to petitioner's contention (Pet. 12–14), there was no transfer in substance of voting power from petitioner to the foreign preferred stockholders (App. A–22—A–28, B–11).[7]

2. Although petitioner concedes (Pet. 8) that there is no conflict of decisions with respect to the particular question involving Section 957, it seeks review on the basis of an alleged conflict with decisions interpreting the phrase "total combined voting power" as it is used in other Code provisions. In support of its

[6] The Tax Court and the court of appeals below reached the same result in a similar case, in *Kraus* v. *Commissioner*, 59 T.C. 681, affirmed, 490 F. 2d 898 (C.A. 2).

[7] Compare Treasury Regulations, Section 1.1563–1(a)(6), which defines "total combined voting power" in essentially the same manner.

contention, petitioner cites (Pet. 11) *Granite Trust Co.* v. *United States*, 238 F. 2d 670 (C.A. 1); *Commissioner* v. *Day & Zimmermann*, 151 F. 2d 517 (C.A. 3); and *Avco Mfg. Corp.* v. *Commissioner*, 25 T.C. 975, vacated and remanded, 57–2 U.S.T.C. par. 10,021 (C.A. 2). These decisions hold that for purposes of Section 112(b)(6) of the 1939 Code (now Section 332 of the 1954 Code), a transfer of stock will defeat the operation of the statute which requires ownership by the taxpayer-corporation of "at least 80 per centum of the total combined voting power of all classes of stock entitled to vote and * * * at least 80 per centum of the total number of shares of all other classes of stock * * *."

These cases do not conflict with but to the contrary actually support the decision below. They all turn upon the fact that the transfers were bona fide and that "there had been no showing of any understanding existing between [the transferor and the transferee] by which the [former] was to retain any sort of interest in the securities or in the proceeds therefrom" (238 F. 2d at 676). See also App. B–11, n. 4. Here, on the other hand, there was a clear understanding that all of the Garlock, S.A., preferred shares would be voted in accordance with petitioner's wishes.[8]

[8] Petitioner also cites *Trotz* v. *Commissioner*, 361 F. 2d 927 (C.A. 10), and *Mitchell* v. *Commissioner*, 300 F. 2d 533 (C.A. 4), but those cases are also distinguishable. They involve Section 1239 of the Internal Revenue Code of 1954, which has a different test based upon "value." Although certain evidentiary facts are probative of both "voting power" and "value," the decision below does not equate the two concepts, as petitioner implies. Indeed, the issue here is not the meaning of "voting power" but whether "voting power" had in fact been given to the preferred shareholders.

Petitioner's further reliance (Pet. 14–16) upon *United States* v. *Byrum*, 408 U.S. 125, is misplaced. That estate tax decision held that for purposes of Section 2036(a) of the Code, a decedent did not have the "right" to designate the enjoyment of the income or the "possession or enjoyment of" stock transferred to a revocable trust even though the decedent had retained voting control over the corporation. Unlike this case, *Byrum* did not involve the question whether the decedent had voting control over the corporation, for it was undisputed that he did. Rather, the issue was whether such voting control required the inclusion of the stock in the decedent's gross estate under Section 2036.

3. Petitioner's constitutional attack upon Subpart F, renewed in this Court (Pet. 16–20), was correctly characterized by the court of appeals as bordering on the frivolous (App. B–12). A similar challenge to Subpart F was recently rejected by the Tenth Circuit in *Estate of Whitlock* v. *Commissioner*, Nos. 73–1497, 73–1498 (decided April 22, 1974), affirming 59 T.C. 490, which cited the decision below with approval. There is no constitutional distinction between taxing the earnings of a partnership to the partners, whether or not distributed (*Heiner* v. *Mellon*, 304 U.S. 271, 280–281; *United States* v. *Basye*, 410 U.S. 441, 453–454), and taxing corporate income to stockholders of a controlled foreign corporation or foreign personal holding company (*Helvering* v. *Nat. Grocery Co.*, 304 U.S.

282, 288).[9] See also *Moline Properties* v. *Commissioner,* 319 U.S. 436, 439. Decisions of this Court have long established that where income is subject to the taxpayer's dominion, power or control, the imposition of a tax is justified and valid. *Griffiths* v. *Commissioner,* 308 U.S. 355, 357–358; *Higgins* v. *Smith,* 308 U.S. 473, 477–478; *Helvering* v. *Clifford,* 309 U.S. 331, 337; *Harrison* v. *Schaffner,* 312 U.S. 579, 580–582. The mere lack of physical receipt will not defeat taxation. *United States* v. *Basye, supra; Heiner* v. *Mellon, supra; Helvering* v. *Bruun,* 309 U.S. 461; *Helvering* v. *Horst,* 311 U.S. 112; *Hormel* v. *Helvering,* 312 U.S. 552.

Contrary to petitioner's argument (Pet. 17–19), the decision below does not conflict with *Eisner* v. *Macomber,* 252 U.S. 189. There, the Court held that it was unconstitutional under the Sixteenth Amendment to require a person to include in income a common stock dividend on common stock. Since such a dividend

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[9] In *Helvering* v. *Nat. Grocery Co., supra,* the Court held constitutional the imposition of a surcharge on income of a corporation availed of for the purpose of preventing a surtax on its shareholders. The Court stated (304 U.S. at 288):

"If, having a partner, the business had been carried on as a partnership, all the year's profits would have been taxable to the partners individually, although these had been retained by the partnership undistributed. * * * Kohl, the sole owner of the business, could not by conducting it as a corporation, prevent Congress, if it chose to do so, from laying on him individually the tax on the year's profits."

Significantly, the Court cited with approval the personal holding company and accumulated earnings tax provisions which similarly tax shareholders for undistributed corporate earnings. See also *Eder* v. *Commissioner,* 138 F. 2d 27, 28 (C.A. 2).

merely decreased the value of each share of common stock without increasing the interest of the shareholder in the corporation, it did not constitute income.

The earnings of Garlock, S.A., however, are income within the meaning of the Sixteenth Amendment, and *Eisner* v. *Macomber*, does not bar the taxation of a corporation's income to a controlling shareholder as in the present case. Moreover, in *Helvering* v. *Brunn*, 309 U.S. 461, the Court rejected the concept that taxable gain could arise only when the taxpayer was able to sever increments from his original capital, which was one of the theoretical bases of *Eisner* v. *Macomber, supra.* See *Helvering* v. *Griffiths*, 318 U.S. 371, 393–394. See also *Helvering* v. *Horst, supra; Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426, 430–431; *General American Inv. Co.* v. *Commissioner*, 211 F. 2d 522, 523 (C.A. 2), affirmed, 348 U.S. 434.

CONCLUSION

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

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MAY 1974.

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 951 [as added by Sec. 12(a), Revenue Act of 1962, P.L. 87-834, 76 Stat. 960, 1006]. AMOUNTS INCLUDED IN GROSS INCOME OF UNITED STATES SHAREHOLDERS.

(a) AMOUNTS INCLUDED.—

(1) *In general.*—If a foreign corporation is a controlled foreign corporation for an uninterrupted period of 30 days or more during any taxable year beginning after December 31, 1962, every person who is a United States shareholder (as defined in subsection (b)) of such corporation and who owns (within the meaning of section 958(a)) stock in such corporation on the last day, in such year, on which such corporation is a controlled foreign corporation shall include in his gross income, for his taxable year in which or with which such taxable year of the corporation ends—

(A) the sum of—

(i) except as provided in section 963, his pro rata share (determined under paragraph (2)) of the corporation's subpart F income for such year, and

(ii) his pro rata share (determined under section 955(a)(3)) of the corporation's previously excluded subpart F income withdrawn from investment in less developed countries for such year; and

(B) his pro rata share (determined under section 956(a)(2)) of the corporation's increase in earnings invested in United States property for such year (but only to the extent not excluded from gross income under section 959(a)(2)).

(2) *Pro rata share of subpart F income.*—The pro rata share referred to in paragraph (1)(A)(i) in the case of any United States shareholder is the amount—

(A) which would have been distributed with respect to the stock which such shareholder owns (within the meaning of section 958(a)) in such corporation if on the last day, in its taxable year, on which the corporation is a controlled foreign corporation it had distributed pro rata to its shareholders an amount (i) which bears the same ratio to its subpart F income for the taxable year, as (ii) the part of such year during which the corporation is a controlled foreign corporation bears to the entire year, reduced by

(B) the amount of distributions received by any other person during such year as a dividend with respect to such stock, but only to the extent of the dividend which would have been received if the distribution by the corporation had been the amount (i) which bears the same ratio to the subpart F income of such corporation for the taxable year, as (ii) the part of such year during which such shareholder did not own (within the meaning of section 958(a)) such stock bears to the entire year.

(3) *Limitation on pro rata share of previously excluded subpart F income withdrawn from investment.*—For purposes of

paragraph (1)(A)(ii), the pro rata share of any United States shareholder of the previously excluded subpart F income of a controlled foreign corporation withdrawn from investment in less developed countries shall not exceed an amount (A) which bears the same ratio to his pro rata share of such income withdrawn (as determined under section 955(a)(3)) for the taxable year, as (B) the part of such year during which the corporation is a controlled foreign corporation bears to the entire year.

(4) *Limitation on pro rata share of investment in United States property.*—For purposes of paragraph (1)(B), the pro rata share of any United States shareholder in the increase of the earnings of a controlled foreign corporation invested in United States property shall not exceed an amount (A) which bears the same ratio to his pro rata share of such increase (as determined under section 956(a)(2)) for the taxable year, as (B) the part of such year during which the corporation is a controlled foreign corporation bears to the entire year.

* * * * *

SEC. 957 [as added by Sec. 12(a), Revenue Act of 1962, *supra*]. CONTROLLED FOREIGN CORPORATIONS; UNITED STATES PERSONS.

(a) GENERAL RULE.—For purposes of this subpart, the term "controlled foreign corporation" means any foreign corporation of which more than 50 percent of the total combined voting power of all classes of stock entitled to vote is owned (within the meaning of section 958(a)), or is considered as owned by applying the rules of ownership of section 958(b), by United States shareholders on any day during the taxable year of such foreign corporation.

* * * * *

Treasury Regulations On Income Tax (1954 Code) (26 C.F.R.):

§ 1.857-1 DEFINITION OF CONTROLLED FOREIGN CORPORATION.

* * * * *

(b) PERCENTAGE OF TOTAL COMBINED VOTING POWER OWNED BY UNITED STATES SHAREHOLDERS—

(1) *Meaning of combined voting power.* In determining for purposes of paragraph (a) of this section whether United States shareholders own the requisite percentage of total combined voting power of all classes of stock entitled to vote, consideration will be given to all the facts and circumstances of each case. In all cases, however, United States shareholders of a foreign corporation will be deemed to own the requisite percentage of total combined voting power with respect to such corporation—

(i) If they have the power to elect, appoint, or replace a majority of that body of persons exercising, with respect to such corporation, the powers ordinarily exercised by the board of directors of a domestic corporation;

(ii) If any person or persons elected or designated by such shareholders have the power, where such shareholders have the power to elect exactly one-half of the members of such governing body of such foreign corporation, either to cast a vote deciding an evenly divided vote of such body or, for the duration of any deadlock which may arise, to exercise the powers ordinarily

exercised by such governing body; or

(iii) If the powers which would ordinarily be exercised by the board of directors of a domestic corporation are exercised with respect to such foreign corporation by a person whom such shareholders have the power to elect, appoint, or replace.

(2) *Shifting of formal voting power.* Any arrangement to shift formal voting power away from United States shareholders of a foreign corporation will not be given effect if in reality voting power is retained. The mere ownership of stock entitled to vote does not by itself mean that the shareholder owning such stock has the voting power of such stock for purposes of section 957. For example, if there is any agreement, whether express or implied, that any shareholder will not vote his stock or will vote it only in a specified manner, or that shareholders owning stock having not more than 50 percent of the total combined voting power will exercise voting power normally possessed by a majority of stockholders, then the nominal ownership of the voting power will be disregarded in determing which shareholders actually hold such voting power, and this determination will be made on the basis of such agreement. Moreover, where United States shareholders own shares of one or more classes of stock of a foreign corporation which has another class of stock outstanding, the voting power ostensibly provided such other class of stock will be deemed owned by any person

or persons on whose behalf it is exercised or, if not exercised, will be disregarded if the percentage of voting power of such other class of stock is substantially greater than its proportionate share of the corporate earnings, if the facts indicate that the shareholders of such other class of stock do not exercise their voting rights independently or fail to exercise such voting rights, and if a principal purpose of the arrangement is to avoid the classification of such foreign corporation as a controlled foreign corporation under section 957.

* * * * *

U.S. GOVERNMENT PRINTING OFFICE: 1974